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THESIS

Methods of Financing American Industries

by

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Methods of Financing American Industries

CONTENTS

Chapter

I. History of American Investment Banking------------------ 4
   A. History and Beginning---------------------------------- 4
   B. Early Period of Capital Accumulation------------------ 4
   C. Internal Improvements and the Import of Capital----- 6
   D. The Domestic Capital Market-------------------------- 7
   E. Recuperation and Growth-------------------------------- 8
   F. The Civil War and the Rise of the American House---- 9
   G. Railroad Building and Industrial Development-------- 9
   The Rise of the International Bankers--------------- 9
   H. Trust and Consolidation Period----------------------10
   I. The World War Period----------------------------------11
   J. The Securities and Exchange Act---------------------12
   K. The World War II Period-----------------------------13
   L. Post-War Financing-----------------------------------14

II. The Demand For Capital in American Industries-----------17
   A. Establishment of a New Business---------------------17
   B. Need For Expansion as in Building and Machinery-----20
   C. Need For Working Capital----------------------------23
   D. Refunding of Outstanding Securities-----------------26
   E. Recapitalization-------------------------------------26
   F. Mergers--27
   G. The Purchase of Large Blocks of Closely Held Stocks-28

III. The Supply of Capital-------------------------------------29
   A. Institutional Investors------------------------------29
      1. Life Insurance Companies-------------------------30
      2. Commercial Bank-----------------------------------32
      3. Eleemosynary Institution-------------------------33
      4. Other Business Corporations---------------------34
   B. Investing Institutions-------------------------------34
      1. Savings Bank---------------------------------------35
      2. Commercial Bank's Saving Department--------------36
      3. Trust Company-------------------------------------36
      4. Investment Trust---------------------------------38
      5. Mortgage Bank-------------------------------------38

IV. The Supply of Capital - Continued-----------------------40
   A. Facilitating Institutions---------------------------40
      1. Brokers--40
      2. Dealers--41
      3. Stock Exchanges-----------------------------------43
   B. Individuals---46

Chapter

V. The Role of Investment Banking------------------------- 49
  A. Purchase of Securities----------------------------- 50
  B. Sale of Securities--------------------------------- 52
  C. Trading in Issued Securities---------------------- 54
  D. Statistical Analysis of Securities---------------- 55
  E. Mechanical Handling of an Accounting for The Transactions of the Concern------------------- 58

VI. Methods of Financing Corporations--------------------- 59
  A. First Mortgage Bonds------------------------------ 61
  B. Debenture Bonds----------------------------------- 63
  C. Convertible Bonds--------------------------------- 64
  D. Income Bonds-------------------------------------- 66
  E. Direct Loans by Insurance Company----------------- 67
  F. Direct Loans From College Endowment Funds---------- 68

VII. Methods of Financing Corporations - Continued---------- 69
  A. Preferred Stocks---------------------------------- 70
    1. First and Second Preferred---------------------- 72
    2. Convertible Preferred--------------------------- 72
    3. Participating Preferred------------------------- 73
    4. Income Preferred-------------------------------- 75
  B. Common Stock-------------------------------------- 76
  C. Short-Term Borrowing------------------------------ 77
    1. Unsecured Bank Loans---------------------------- 78
    2. Sale of Promissory Notes on the Open Market----- 79
    3. Discounting Trade and Banker's Acceptance------- 79
    4. Loans Secured by Stock Market Collateral-------- 80
    5. Commodity Loans--------------------------------- 80
    6. Assignment of Receivables----------------------- 81
    7. Miscellaneous Methods of Short-Term Borrowing--- 81

VIII. Case History of a Recent Financing by Investment Bankers--- 82

IX. Conclusion - Future Trends of Financing---------------- 86
  A. Importance of the Business Cycle------------------ 86
  B. Future Taxation Trends---------------------------- 87
  C. Possible Government Controls of Interest Rates----- 89
  D. Popularity Trends--------------------------------- 91
  E. Growth Factor of American Industries--------------- 95
  F. Foreign Markets For Capital----------------------- 96
  G. Basic Soundness of American Banking Business------- 97

Bibliography Book--------------------------------------101

Pamphlets ------------------------------------
Periodicals ----------------------------------

Methods of Financing American Industries

I. History of American Investment Banking

The investment banking institutions, with their various functions of investigation, underwriting, and marketing securities, are of comparatively recent development, their history running parallel with that of the corporate form of industry.

A. History and Beginning

Since colonial days many changes have occurred in the methods followed and in the institutions devised to issue and sell securities.

The first investment activity was an abortive effort before the Revolution in the form of Mortgage banks. The colonists sought to establish these banks in hope that they would issue currency to them in return for mortgages on their farms. The second attempt of investment activity was a result of the Revolution whereby it was realized that a central bank was needed to help aid the government finance the republic and regulate currency.

B. Early Period of Capital Accumulation

A rapid accumulation of capital occurred in the seaboard cities of Philadelphia, New York, Boston, and Baltimore as a result of the Napoleonic Wars in Europe. However, it was not adequate to permit the sale of any large

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issues of securities toward the financing of large enterprises. This situation changed when the European wars reached a more advanced stage. There was a gradual repatriation of both government bonds and shares in the Bank of the United States with the rise in money rates abroad caused by the great conflict and the rapid accumulation of capital within this country.

> "The methods of raising capital were primitive because no investment banking mechanism existed. The shares in these enterprises were as a rule offered directly to the public at some tavern or other public meeting place. There the investor would appear in person, and his name and the number of shares desired would be inscribed in great 'books'. After the original flotation of the shares in this way, those of the larger companies attracted the interest of brokers, who often gave their quotations for publications to the newspapers and periodicals of the time. In order to acquire securities for sale, these brokers would at times subscribe for new issues in their own names." (1)

In 1800, the first formal stock exchange was organized and opened in Philadelphia, the commercial and financial metropolis at the close of the Revolution. This seaboard city retained this financial primacy practically down to the War of 1812.

The War of 1812 had to be financed entirely at home with a result that it did show that capital accumulation had advanced to a point where large sums could be raised in the

1. H. Parker Willis, Investment Banking, 1936, p. 209

domestic market.

C. Internal Improvements and the Import of Capital

> "Following the close of the War of 1812, three important factors combined to change investment banking conditions in this country radically, In the first place, a mania for internal improvements arose which created a need for large amounts of capital far in excess of visible supplies, whereas previously the accumulation of capital here seemed to equal domestic requirements. In the second place, the close of the war in Europe resulted in a surplus of capital in England which eagerly sought the higher rates of return available abroad. In the third place, nascent industrial development in New England and other seaboard areas, and the opening up of new areas across the Appalachians, sharply reduced the supply of free capital within the country available to finance the internal improvement programs." (1)

About 1817, American securities took on increased popularity throughout Britain. The collapse of South American securities on the London market in 1825 was an important factor in the stimulus of British investments in this country.

> "By 1836, there had been invested $90,000,000 in canals and railways in the northern states. More than half of this sum was raised through the pledging of state credit and the sale of bonds in England. In addition, the southern states borrowed for both internal improvements and, more especially, land mortgage banks, since the plantation system in the South created capital needs for the purchase of slaves, etc." (2)

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1. H. Parker Willis, Investment Banking, 1936, p. 210
2. Ibid p. 211

In the period around the 1830's, large blocks of State and municipal securities were purchased and loans were made to promoters with stocks and bonds as collateral by the commercial banker. State bonds and securities of American business enterprises were active and popular with foreign bankers. The popularity of these bonds and securities was influenced by the economic outlook in this country and the wars abroad. Many American branches and connections were established and maintained in this country by foreign houses.

D. The Domestic Capital Market

The domestic capital market began to assume sizable proportions during this period with foreign capital contributing little in the financing of American manufacturing industries, such as the textile mills of New England and the iron manufactories of Pennsylvania.

In the thirties, exchanges were being built up in the leading centers by brokers, being supported mostly by a growing class of merchants and manufacturers who invested in relatively small amounts and appeared at the time to favor stocks in railroads and financial institutions. A group of insurance companies, a number of moneyed families in the seaboard cities such as traders and shipowners, and banks which were then springing up everywhere constituted the rest of the American capital market

The panic of 1837 caused much disturbance in the

capital market at home. Banks operated at a loss, capital was cut off from abroad, and the development of investment banking was retarded with the separation of investment banking activities from commercial banking. The three years following the panic closed a period of rapid internal development with widespread speculation in railroad and miscellaneous securities. During this period a number of canals and railways were built, and the frontier was pushed farther westward to the Mississippi along with the development for the first time of a substantial capital market.

E. Recuperation and Growth

The growth of the country continued at a slower pace with railroad building attracting the most interest during this era. The banks played the important role in financing the railroads. The financing was done by the advancing of money by banks to the railroads whereby the banks secured representation on the boards of directors.

Speculation had slowed down comparable to the preceding era. However, speculation continued and gradually increased with the popularity of railroad and miscellaneous securities. This growing speculation caused a rapid expansion of the exchanges in the larger cities.

Interest abroad began to revive in the late forties, but the investors favored only railroad securities issued by private corporations. Speculation once again became active, especially in stocks. Because of the great demand for

securities the supply of the call money market had to increase.

F. The Civil War and the Rise of the American Bond House

By the opening of the Civil War, Investment banking machinery had grown to sizable proportions as a result of financing the railroads and states and cities. Before the development of this machinery, new security issues were often offered directly by the company to the public. However, with this machinery, the company turned to banking and brokerage houses and gave them a small fee for guaranteeing the sale of the issue, the unsold portion being taken by the underwriters.

During the Civil War the American Bond House witnessed the first outburst of active bond selling. This came about as a result of the sale of government bonds.

G. Railroad Building and Industrial Development
The Rise of the International Bankers

The great railroad systems of that time dominated the period from the Civil War to the panic of 1893. Along with this domination, wild speculation occurred on the American stock exchanges in stock and bond issues of railroad companies. They as well as many investment banking houses, were caught in the panic of 1873, which terminated this period of speculation. Investment bankers were unable to maintain their financing of some railroads during the panic of this time, which caused the failure of many of the railroad systems.

The public became wary and timid in respect to new security issues for many years thereafter because of the failure of the investment bankers.

About 1871, there was the formation of a syndicate of investment bankers as a result of failure by the Federal Government to raise capital funds abroad. In the opinion of some, this was the first example of underwriting in America. Not until 1875 did the process of syndicate underwriting of securities become well known to the financiers of England and America. The end of this period witnessed the rise of the international banking houses to a position of complete domination in the financial organization.

Industrial development in this era was rapid, but it assumed largely the form of relatively small individual enterprises and local corporations. This period of the growth of numerous small enterprises made possible the combination and trust era.

H. Trust and Consolidation Period

The few years following the panic of 1893 caused a complete change in the financial position of this country. In the words of Noyes, it was a long step from

> "the crippled industrial and financial state of 1894, with the country's principal industries declining, its great corporations drifting into bankruptcy and its Government forced to borrow on usurious terms from Europe to maintain the public credit", to that of "a community whose prosperity had become the wonder of the outside world, whose productive

> industries had developed such strength that 'American invasion' was discussed abroad as threatening ruin to our European competitors." (1)

With the vast issue of securities, public confidence was needed to secure the sale of these issues. Therefore, the great international banking houses were given leading roles in accomplishing this task. Stock exchanges also became popular as the turnover of securities increased.

The period from 1893 to 1914 marked an era of reorganization and consolidation of railroads and many small industrial plants. The investment banking business developed as the investment bankers helped absorb the vast amounts of public utility and industrial securities that came into the market. Speculation and fraud increased with the expansion of public interest in financing.

I. The World War I Period

Before the war, the investment bankers in this country depended at least to a partial extent upon the foreign market to absorb new security issues. Institutional investors, estates, and a limited number of wealthy investors constituted the supply of capital to this country.

> "The war-time period of American finance was characterized by an unparalleled expansion, first, of the industrial nation, so that within ten years what had been vaguely predicted in 1897 became an actual fact, and the primacy in world finance definitely passed to this country. With the industrial consolidation movement largely completed before the war began, the basic industries were in a position to expand

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1. A. D. Noyes, Forty Years of American Finance, 1919, p. 257

> without difficulty as the need arose; and the financial strength and efficiency of many of the leading corporations permitted them a large degree of flexibility which stood them in good stead when Europe began to call upon this country to help supply war materials and supplies to her armies, as well as food and other materials available in reduced quantities because of the absence of millions of farmers and city workers at the front." (1)

The situation continued without much change with the entrance of this country into the war in 1916. The demand by Europe was now met through direct advances by this government, instead of the resale of American securities owned abroad or the flotation of foreign bonds here.

Wartime finance stimulated popular ownership of securities. With the vast increases in the number of investors, the Liberty Loan campaigns, and customer and employee ownership plans as carried out by individual corporations, investment banking houses after the war helped develop the security buying habit in the American people. American securities that had been held by investors abroad were now being absorbed at home and many foreign loans, as well as a large volume of new domestic loans were being floated.

J. The Securities and Exchange Act

In 1932 an investigation of security dealings, banking practices, and their effects was authorized by the Senate Committee on Banking and Currency. With this investigation

1. H. Parker Willis, Investment Banking, 1936, p. 234

Congress decided to bring forth the enactment of two Acts: the Banking Act of 1933, and the Securities Act of 1934. Many practices and abuses which were disclosed by the Congressional investigation were completely forbidden and others severely curbed. The next era of investment banking was to be greatly affected as a result of these Congressional investigations.

> "A vital change took place in the investment banking business, beginning with the enactment of Federal legislation to protect investors and to control security markets. Not only were the processes of underwriting syndication, and distribution of securities adjusted to the conditions created by the Securities Exchange of 1933, and the Securities Exchange Act of 1934, and to rules and regulations subsequently issued by the Securities and Exchange Commission, but the very organization of the investment banking houses and retail distributors was changed." (1)

For two years after the passage of the acts there was little corporate financing. Legislation and the changed economic and financial conditions of the country in the next four years helped to develop the mechanism of security underwriting and distribution.

K. The World War II Period

This period will go down in history as the era of low money rates. This, without question was forced upon the investment bankers by a desire on the part of Government Officials to issue Government Bonds at extremely low rates of

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1. Charles W. Gerstenberg, Financial Organization and Management of Business, 1945, p. 392

interest. This naturally cut the cost of servicing the ever mounting Government debt.

It could readily be seen that on a total Government debt of a rising $250,000,000,000.00, that even a saving of one-quarter of one per cent would amount to a tremendous sum. Thus, billions in Government Bonds were bought up by banks, institutions and individuals on as low a coupon rate as two and one half per cent on the longer term issues. Of course, the extremely shorter term certificates, etc. came out on a seven-eighth basis.

While this heavy financing was taking place on the part of the Government, relatively little was being done by industrial corporations. Patriotism called for the purchase of War Bonds first and foremost.

What little corporate financing there was consisted mostly of refunding at much lower coupon rates. The five per cent issues were called in and replaced by three's and three and one-half's. Some issues even came out at two and three-quarters. Even preferred stock issues carrying a dividend rate of four percent were issued to replace five and one-half and six per cent bonds.

L. Post-War Financing

Soon after hostilities ended Government economists started planning to firm up money rates. Inflationary fires began to burn so brightly that steps had to be taken to dry

up the money supply at least until the production lines could catch up to the tremendous demands.

The first sign of the times was the firming up, however slight, in the very short term money markets. Then the real drive started around Christmas time of 1947 when the Government operating through the Federal Reserve Board lowered support level on their Government Bond buying program.

In spite of the tremendous expansion by industry during the war period, many corporations needed funds for peacetime enlargement. It was found that since low coupon bonds were in such demand and preferred stock issues were going over so readily that common stock issues could be floated with comparative ease. Thus, during the post-war period, millions of dollars of stock issues were brought out and absorbed by the public.

However, with the Government desires to smother the inflationary fires through tighter control of money rates investment bankers found that corporations would have to pay more for their money. Some issues which started out to be three and one-half per cent issues, ended up by coming out at four or even four and one-quarter per cent.

The suit against the Investment Banking Industry, also was a big event of the post-war period. The Department of Justice charged the Investment Bankers with monopolistic practices. Just how this suit will come out or its effect

on the industry, only time will tell. Many of these anti-trust suits are announced on the front page of the morning newspaper in glowing headlines. The final settlement is usually buried inside on some little read page. This may be true of the present action.

II. The Demand for Capital in American Industries

The financing of individual industries generally follows a fairly uniform course. In the early stage of an industry's life, capital is difficult to secure, and financing takes the form of speculative stock issues. Banking houses are cautious because they do not wish to risk their reputation and prestige on a new and untried security. Then, as individual enterprises become firmly established and earning power is more definitely developed, a great deal of financing takes place. Finally, the industry tends to reach a saturation point, where it has expanded sufficiently to meet the demand for its product it has expanded sufficiently to meet the demand for its product and services. As a result, the new financing tends to fall off.

A. Establishment of a New Business

In the launching of a new enterprise many disadvantages are incurred in the raising of capital. Banking houses are wary of the risk for they have no gauge to go by. The seasoning of a new enterprise is lacking and in the words of Husband, "promoters of a new company frequently become beggars instead of choosers of capital." (1)

Capitalization must vary according to the field of activity. Funds in part may be advanced by the promoter. Where income is variable and uncertain, bonds must be avoided and stock used to raise the capital funds.

1. William H. Husband, Modern Corporation Finance, 1947, p. 231

If any doubt exists as to covering the preferred dividends, then only common stock should be issued.

The funds for financing during the organization, or meeting cost of all intangible property from the very start until the time when the business is in actual operation, are usually advanced by the promoter.

> "This embraces expenses for such things as investigation of the project; procuring parties who may be willing to participate; preliminary engineering and legal advice on the project; a canvass of territory to ascertain whether sufficient business can be obtained; an estimate of the cost of the plant, the securing of the franchise." (1)

The financing of construction, which incurs the cost of all the tangible property, is usually accomplished through the proceeds from the sale of stocks and bonds of the company. The financing of the business after the preceding expenses have been taken care of is also accomplished by the sale of the company's securities. The cost of construction embraces

> "the cost of real estate; labor, material, and contractors; engineering; the expense of company organization during construction; stores and supplies; the interest during construction; taxes and insurance during construction; legal expenses; working capital; and the expenses of financing including bankers' commissions, discounts on bonds, and the promoter's profit". (2)

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1. Joseph Howard Bonneville, Organizing and Financing Business
   Lloyd Ellis Dewey 1945 p. 17
2. Ibid p. 18

The charges included in the cost of acquiring or establishing the business includes such charges as

> "advertising, canvassing for business; interest on the cost of operation in excess of income until the business becomes self-supporting; and taxes and insurance during that time". (1)

When a new business is being organized, bonds originally will not be used unless the earnings outlook appears to be steady and certain. Some small concerns will acquire tangible properties subject to ordinary real estate mortgages in order to reduce the amount of funds required from the general public.

If stocks are to be issued to finance the new concern various forms may be issued to represent the different interest of the owners. Preferred stock may be issued by industrials whenever it is warranted. The issuance requires t that the earnings over a period of time be sufficient to cover the dividends without causing undue curtailment of operations. If the promoters wish to keep control, the preferred stock may be made non-voting. To increase the attractiveness of the stock the holders may be given the right to participate in the earnings. The redemption feature may also be included to rid the company of the preferred stock when earnings become large and stable. If market conditions require the inclusion of speculative features, the preferred stock may be made

1. Joseph Howard Bonneville, Organizing and Financing Business
   Lloyd Ellis Dewey   1945, p. 18

convertible or be issued with common stock purchase warrants.

In the financing of a new enterprise through the issue of stock, common stock should be used as much as possible to provide the bulk of the financing. It shows evidence of belief in the project in that the promoters generally take the common stock, which represents the residual claim on earnings.

B. Need for Expansion as in Building and Machinery

Besides requiring capital for its original establishment, a business frequently requires funds for expansion. A concern may find that the demand for its products exceeds its facilities for manufacture, and that it must expand or invite competitors to enter and supply the market. Often, lower costs may be obtained by replacing labor with machinery; a new and modern plant must be built to avoid or meet competition.

When capital is obtained from outside sources to meet the cost of extensions, it may be had through the sale of temporary obligations in the form of notes, or through that of permanent obligations in the form of long-term bonds or stock.

> "Temporary financing may be based upon two different financial presumptions. In one case, the directors of the corporation may issue the short-term notes in order to pay for extensions and improvements in structures and other permanent or fixed property, on the assumption that bonds may be sold more advantageously when the notes mature than at the time of

> issue. In the other case, the directors may issue short-term notes on the assumption that when the notes mature the earnings from the p property which was bought from the proceeds of their sale will afford sufficient free capital to meet their payments." (1)

Many businesses prefer to grow gradually and by so doing they re-invest a portion of their earnings each year. As a result they avoid the creation of fixed charges which arise from the borrowing of funds. Also, the re-investment of earnings restricts ownership and control to the original owners without direct call upon them for additional investment. The use of notes is usually used and more adaptable to meet short term needs of increased capital for either personal, emergency, or general expansion purposes.

With the regard to the class of securities desirable for the purpose of financing additions to long-time assets, this is conditioned to some extent by the nature of the demand for securities at the time of expansion. It also depends on the existing capital structure and funded debt of the issuing company, and the amount and dependability of the company's net income.

Capital for future expansion should be raised by means that will keep down the annual cost, especially when such funds are desired for investment in permanent additions or improvement to the plant.

1. Arthur Stone Dewing, The Financial Policy of Corps., 1941 p. 1083

> "Bonds are generally more economical than either notes or stocks for the following reasons: the bond interest rate is commonly lower than that on short term notes; also, it amounts to less than the business earns on the borrowed funds and thus leaves available for dividends to stockholders the difference as an increased earning on their stock, upon the principle of trading on the equity; also, the selling cost of bonds is usually smaller than that of stock because the wide market for bonds in large amounts renders the marketing of bonds easier and cheaper than marketing of stock. It is estimated that on the average the cost of capital raised by long term bonds is from 1% to 3% lower than that of capital raised by the sale of stock." (1)

Bonds of course, should never be used when there is any danger that the interest cannot be met regularly.

The sale of stock has the advantage that it creates no fixed charges. Also, the stockholders cannot foreclose if the expanding company should for some years be unable to pay substantial dividends on the increased amount of stock. However, as a result of expansion it is expected that there will be an increase in income sufficient to pay the entire stock dividends equal to or temporarily lower than those paid prior to the expansion.

As a matter of practice, the form of securities to issue is something that can best be decided in consultation with the investment banker at the time it is desired to secure the capital.

1. Joseph Howard Bonneville, Organizing and Financing Business
   Lloyd Ellis Dewey 1946, p. 169

C. Need for Working Capital

> "As its name implies, working capital is what you use, from day to day in running your business. Lenders figure that it should 'turn over' at least every six months, and therefore it has to be replaced within the same such period. Working capital will provide raw materials, money for payroll, running expenses within reason, and liquidation of current debts. Specifically, it will buy new machinery, make improvements on plant, real estate or place of business, pay past due and long time indebtedness, carry on advertising campaigns, develop patents, conduct research, and enable you to do things which may not be realized on within six months." (1)

The amount of capital required varies from business to business. In the case of industries and manufacturing enterprises working capital in industries will primarily be in its conversion into operation plant structure, while a large share of the working capital in manufacturing enterprises is more likely to be changed in form by conversion into the finished product.

> "When a new concern is first organized and financed, the working capital will be principally, if not entirely, obtained from the original financing. Very soon a portion of the cash will be transferred into raw materials, wages, supplies, and a host of other current operating accounts. These expenditures will be reflected in the value of the goods-on-hand consisting of raw materials, goods-in-process, or finished product. The finished product will then be sold, and for the typical business the value will be transferred to accounts receivable. If the sales have been made at satisfactory prices, the amount of the accounts receivable should be larger than the expenses incurred for raw materials and other items. Gradually, the account receivable will be collected and the working capital will have re-

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1. William Hurd Hillyer, Keys to Business Cash. 1942, p. 3

> turned to its original starting place, cash,
> from which the cycle will be repeated." (1)

The flow of this cycle may be continuous in theory, but in practice it will be irregular because of the fluctuations in the volume of sales and in the changing price levels of raw materials, labor and other costs.

Methods used in the attaining of working capital may vary according to the situations involved. Additions may be made to the working capital fund through special financing, or it may be changed by leaving in the fund the profits made on sales. Corporations ordinarily do not pay out all of their earnings as dividends over any period of years. Needs of capital increase as corporations grow in size and volume making the retaining of earnings popular.

In comparison with stocks and surplus, bonds have the difficulty of creating fixed charges. If a portion of the working capital should be idle, not only would earnings be lost but also it would be necessary to pay a penalty in the form of interest on the bonds. Therefore, bonds should be used only when the requirements are believed to be permanent, and never for seasonal or temporary purposes. Bonds also have a definite maturity which may appear unimportant, but which creates a future contingency.

A portion of working capital should be accommodated by the sale of stock. The portion of working capital obtained

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1. William H. Husband, Modern Corporation Finance, 1947, p. 561
   James C. Dockeray

by this means provides relief to management from the contingencies of bonds. The use of stock to obtain initial working capital places the corporation on a sound basis and enables it to provide more adequately for later needs by other means.

Corporations may make continuous use of the lending facilities of commercial banks. Loans for temporary working capital purposes are made by all commercial banks. Bank borrowings should ordinarily be the source for a large portion of the extraordinary or temporary working capital needs along with a portion of ordinary current financing. This has the advantage of developing established financial connections for use in times of emergency or of having a ready means of reducing working capital during periods of extreme decline in the volume of business.

When bank facilities are inadequate or it is thought more economical to finance on the open market, the corporation may resort to the use of the commercial paper house.

> "Commercial paper, in the financial sense, means the promissory notes of short duration which large and sound business concerns frequently offer for sale through commercial paper houses on the open market." (1)

This method of finance offers favorable interest rates and good will as a result of widespread ownership of its notes.

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1. Joseph Howard Bonneville, Organizing and Financing Business
   Lloyd Ellis Dewey 1946, p. 202

D. Refunding of Outstanding Securities

If a corporation wishes to raise additional cash for the purpose of replacing issues previously outstanding, they may accomplish this through a large part of new security offerings. Such refunding operations may be for the purpose of paying off a maturing obligations, or a new issue with a lower rate of interest may be offered to reduce the interest on the outstanding bonds. This type of financing is greatest in periods of rising bond prices, and in the earlier periods of a boom in the stock prices.

E. Recapitalization

Recapitalization is the revision of the capital structure of a corporation, with the desire to make the structure more applicable to the period and situations at hand. Just as obsolescence sets in, the financial policy may also be outmoded by changing conditions in the money market. Recapitalization may occur by inducing holders of the company's stock to exchange their existing securities for new ones on a voluntary basis.

> "Broadly speaking, revision of the financial structure may be caused by a state of financial embarrassment, by opportunities to improve the composition or arrangement of the capital structure, and by various conditions of expediency which affect the normal life of the corporation. Financial embarrassment: (1) elimination of a deficit; (2) elimination of accumulated dividends on preferred stock; (3) adjustment for the purpose of recognizing changes in the value of assets. Opportunities to improve the financial structure: (1) to take

> advantage of many market conditions; (2) to provide a more effective way of reaching a larger number of investors; (3) to simplify the capital structure. Conditions of expediency: (1) to accomplish a transition from a closed to an open corporate status; (2) to meet legal requirements." (1)

F. Mergers

> "A merger occurs when two corporations are fused, one of which survives, while the other loses its corporate existence and has its properties combined with those of the company which remains." (2)

In some cases little or no financing is involved in the merging of two corporations. This may be true in the case where it is sometimes brought about entirely or in the main through the exchange of securities among the stockholders of the business. Also, the company acquiring the other company may have available sufficient funds without additional financing.

Where capital is needed it may be possible and desirable for the company to secure all the funds required through an issue of bonds or debentures. Stocks may be used in other cases to accomplish this purpose. This may be preferred stock, par or no par, made attractive by a bonus of common, a warrant for purchase of common, or by a convertible feature. In other cases the financing may be accomplished through the sale of common stock only. However, there are a number of variations

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1. Wm. H. Husband, Modern Corporation Finance, 1947, p. 246
   James C. Dockeray
2. Harry G. Guthmann, Corporate Financial Policy, 1941, p. 573
   Herbert E. Dougall

to which the general public are invited to share in the risks of the new undertaking, as well as the sharing in the potential profits.

G. The Purchase of Large Blocks of Closely Held Stocks

In the early stages of fast growing corporations, the management can usually take care of all the demands for capital. Some times it might be necessary to go to the banks for some short-term loans, but as far as big public financing goes, that remains for a later date.

When the time comes to go to outsiders for money, many times it is necessary for large blocks of stock owned by the management to be purchased by the public in order that larger financing might be done. For example, the original capital set up might call for only 10,000 shares of stock. Due to successful management the book value of these shares might grow to $4,000.00 a share. When more money is needed for expansion this old stock may be split and a portion sold to give better marketability to the stocks.

In some cases, those holding large blocks of stock do not have anyone to leave the stock to when they retire. Here it is helpful to have the investment banker come into the picture to dispose of the stock. This is one of many phases, where the investment banker plays a vital role in the financial picture. Without the investment banker, the large holder might have to sacrifice his large block of stock at a sizable discount from true value.

III. The Supply of Capital

The financial executive, when in need of capital, finds a number of different types of institutions performing their own special functions in the capital market.

Also the individual saver of capital may abandon the responsibility of an investo if he wishes. There are now several types of institutions which assume all, if not nearly all, the responsibility for the routing of the investor's savings into proper channels of investment. The securing of this capital by the institutions is usually accomplished by making an agreement with the investor. These institutions usually stress safety in combination with slow but regular income.

The investment banker, who underwrites the corporation's security offering, is the main contact with the capital market. This investment banker and his associates make it their business to pass on the securities to the investors, institutional as well as individual. Once the securities have been issued, the broker and the stock exchanges furnish a market, thus making the securities marketable from the viewpoint of the investor.

A. Institutional Investors

A large number of important institutions in the course of business accumulate large sums of capital. The capital of these institutions must be kept profitably employed in order to obtain maximum profits, therefore, constituting an im-

portant source of capital for the financial executive. This group of institutions, however, are not formed for the primary purpose of investing funds for individuals.

> "The leader among these institutional investors is the Insurance company. Next comes the commercial banks who also accumulate substantial funds which are kept invested in securities under regulations imposed by state laws. Eleemosynary institutions are gaining control of increasing amounts of money which are being largely invested by them in securities. Finally numerous business corporations have large sums available for general investment as a result of the common practice of American corporations over a period of years of paying out only a portion of their earnings as dividends, regardless of the immediate expansion needs of the enterprise." (1)

1. Life Insurance Company - The insurance companies are considered the most important single class of buyers of investment bonds. These companies invest part of their investment funds in the purchase of new issues and part to purchase from holders of issues previously sold to the public. Their most important function is spreading risks over a community while the investment function is incidental. Their source of funds for investing is a result of an accumulation of reserves.

The business of insurance is steadily growing in importance as the complexity of our economic system increases. The insurance seeks to protect the individual by spreading the economic risks to which he is subject over large numbers of people. This risk is accomplished by collecting small sums

1. H. Parker Willis, Investment Banking, 1946, p. 170
   Jules I. Bodgen

of money from numerous people. The money is then gathered to form a fund to pay losses to the individual subject to the hazard against which it is sought to guard them.

> "It is based on the fundamental rule that death and accidents happen to only a small number of people at one time." (1)

The fund gathered naturally assumes large proportions as the insurance company grows. It must be kept as a reserve from which losses are paid, thus making the insurance company a large holder of capital collected from the whole community. As a result the insurance company incidentally becomes the largest single type of saving and investing machine in the county.

> "The insurance company usually has three funds from which its investments are made. First there is the capital provided by the stockholders, except in the case of a mutual company which is run on the same principle as the mutual savings bank and is owned by the policyholders. In the second place, there is the surplus retained by the company from its past earnings. Last and by far the most important, and constituting the great bulk of the investment fund, there is the premium reserve paid in by the policyholders, and held against future mortality losses." (2)

The life insurance companies met the depression of the early 'thirties in an impressive fashion. While a number of smaller companies failed, the large institutions did not require any direct assistance from the government, their cash

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1. H. Parker Willis, Investment Banking, 1936, p. 146
   Jules I. Bodgen
2. Ibid p. 150

income being sufficient to meet the outgo.

Life insurance companies are fitted to provide long-term capital needs for industry, and are in an ideal position to extend credit. It is expected of course, that the bulk of funds which are placed with life insurance companies are left with them for an extended period of time.

2. Commercial Bank - The commercial bank has been modified by economic and financial developments. Its investment functions have been largely expanded, and thus in addition to being an investment institution it is becoming an institutional investor as well, placing in bonds purchased from the investment banker the funds held on demand, as well as time deposits.

Of all the functions performed by the commercial bank, the most important is that of supplying the needs of business for short-term capital in the form of bank loans. In normal times banks secure a large portion of their earnings from the interest charged on these loans. The basis through which this credit may be extended is through the medium of the deposits of those who are not in immediate need of funds.

In meeting the needs of business enterprises, commercial banks are unusually well qualified to appraise capital needs. They not only constitute the major agency specializing in finance, but through their servicing of the current needs of industry they should be especially familiar with the

complete needs for capital.

The commercial bank, finding it less and less possible to utilize its resources has branched out into other fields, notably security loans and bond investments.

3. Eleemosynary Institutions - Universities, hospitals, churches, charitable organizations and foundations are all important buyers of securities. Their holdings in the aggregate amount to billions of dollars and it increases as the years go by. The increase is a result of the passing on of men who made great fortunes in the past. They follow the usual custom of leaving some part of their wealth to these eleemosynary institutions.

A large and growing group of these institutions constitutes an important factor in the capital market. A large part of the endowment is invested in securities. Among eleemosynary institutional investors, colleges and universities have by far the largest endowment funds, as a group. Most American institutions of higher learning, outside of the state and municipal institutions, do not receive enough in fees or subsidies to cover the cost, so in order to cover the cost the balance is made up from the endowments, from which income is earned. The endowments take the form of land or securities which the institution is expected to retain. However, endowments are increasing in which the institution is at liberty to invest or reinvest at the discretion of its board of trustees.

4. Other Business Corporations - The general run of business corporations are important as institutional investors. Many individual corporations hold hundreds of millions of dollars worth of securities of other corporations. These securities represent companies, both within and without their own individual field of activity.

As a result of their large surpluses, which are in part invested in their own company, the corporations are being recognized as investment organizations. The device of the corporate surplus, designed at first to strengthen a corporation's position in its own industry, has led to the accumulation of large amounts of capital, which are awaiting use in one channel or another. They can place their money in short-term securities in the corporation's own share or they may act virtually as an investment trust, buying and selling new issues as well as old issues previously sold to the public for profit as well as current income.

B. Investing Institutions

The investing institutions, which have been fully developed in this country, can be basically divided into three types. The first type constitutes the savings bank, which operates as an institution of deposit. These deposits are then invested in securities, mainly seasoned issues. The second group comprises investment trusts, mortgage banks, and others which sometimes are referred to as finance companies. This group issues their securities and invests the proceeds of their

sale. The third, and most important type, is the trust company. The trust company manages the funds of each investor individually, which is not possible by the other kinds of investing institutions.

> 1. Savings Bank - "Mutual saving banks are one of the finest achievements of the country. Their record in aiding individual savers and providing capital for industry improvements has been outstanding." (1)

The mutual savings bank possesses a number of important features which give it a distinct character. The conservatism of legislators has largely preserved their character in the changing of savings bank laws. These features are as follows:

> " (1) it is a mutual institution, (2) it is dominantly non-commercial in character, (3) its investments are rigidly restricted by law." (2)

Savings banks receive only time deposits enabling them to place their funds into long term investments, mainly seasoned issues. The reason for this is that they may demand a 30 to 60 day advance notice, varying according to the state law, before the depositors may withdraw their funds. As a result day to day liquidity need not be maintained.

> "The investments of a mutual savings bank are rigidly regulated by state law. In general, these laws limit investment to real estate first mortgages, government and municipal bonds, and a limited group of the better

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1. H. Parker Willis, Investment Banking, 1936, p. 112
   Jules I. Bodgen
2. Ibid p. 112

> railroad and utility bonds meeting specific tests. Stocks are not permitted as investments in any important State bank." (1)

2. Commercial Bank's Saving Department - Commercial banks have long sought time deposits. The national bank may solicit deposits on the same basis as a savings bank, and invest such funds in any fashion which it would invest its ordinary demand deposits. This includes the purchase of marketable bonds. However, a large portion of the time deposits represent large corporations and business men who keep funds this way in order to get a higher rate of interest. At the present time, commercial banks are restricted by law to a rate on savings deposit not in excess of two and one-half per cent.

3. Trust Company - The trust company differs from other investing institutions in that it offers individual and personal service throughout the life and after the death of an investor. The trusts usually involved are of large proportions, but in recent years it has become profitable in smaller trust companies to handle accounts even as small as a few thousand dollars.

The work of a large trust department is grouped around a trust committee composed of the ranking officers of the department which reviews all changes in holdings in individual trust. Research and contact work involves the work which must be done by this committee in order to obtain maximum efficiency. The

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1. H. Parker Willis, Investment Banking, 1936, p. 116
   Jules I. Bodgen

trust departments have been opened by many national and state banks, which act as trustees for individual or for corporate bond issues.

The following roles are played by the trust companies in American investment banking:

> "First, the banking department often possesses a large proportion of time deposits, and thus acts in the same capacity as a stock savings bank. Secondly, the corporate trust business wherein these companies act as trusteed under corporate mortgages and as transfer agents and registrars for stock issues, facilitates the security transactions of other investment banking agencies. In the third place, trust companies, like many commercial banks, may maintain security departments, which operate within the limits laid down by the Banking Act of 1933. Finally, they act as out-and-out investment institutions in the handling of personal trusts." (1)

The owner or investor may retain full control over his investment policy leaving the activity of the trust company to the physical care and handling of the securities. In this case the securities are merely vested in the trust company's name to facilitate transfer, tax reports, etc.

> "As an investing agency, the trust department secures grist for its mill from thousands of personal or charitable trusts set up by individuals for the benefit of other individuals and, to a lesser extent, for charitable or humanitarian purposes." (2)

The corporate enterprise plays an important part in the services rendered by the trust companies.

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1. H. Parker Willis, Investment Banking, 1936, p. 136
   Jules I. Bodgen
2. Shaw, Livermore, Investment Principles and Analysis, 1938
   p. 199

> "A corporation is dependent upon the trust company alike in connection with the raising of fixed capital, with the management of certain of its financial affairs as a going concern and with safe-guarding the interests of both creditors and shareholders in the event of insolvency and financial reorganization." (1)

> 4. Investment Trust - "An investment trust may be defined as an agency which combines the funds of numerous investors through sale of its own securities, and invests them primarily to obtain maximum return and appreciation." (2)

It is one of the institutions designed to assist the investor, offering the investor diversification of his holdings and expert management. The principle business of the trust is that of investing the funds in a varied list of stocks and bonds with its management making the necessary choices and decisions.

Although somewhat similar to savings banks and insurance companies, the basic objectives are much different. The savings banks and insurance companies stress safety as their prime goal, while investment trusts stress appreciation of principle as their main objective.

5. Mortgage Bank - Mortgage banking is a form of investment banking whose purpose is to finance the purchase and development of real properties through the sale of mortgages. The essential idea underlying the whole enterprise is the diversification of risk.

1. Harold G. Moulton, Financial Organization of Society, 1929 p. 288
2. H. Parker Willis, Investment Banking, 1936, p. 125

The mortgage bank performs the function of bringing together capital and opportunity in a particular part of industry. This part of industry improves the soil or adds to it capital improvements in the form of buildings. The mortgage bank finds its chief financial function in developing groups of savers and investors who prefer this kind of security.

IV. The Supply of Capital - Continued

A. Facilitating Institutions

One of the greatest problems involved in the commitment of long-term funds is the creation of a market where the individual investor may dispose of his securities at will. This has been accomplished through what is now called facilitating institutions.

From the social point of view, the benefits derived from an efficient securities market, including brokers and the stock exchanges, are enormous. The cost of securing longer term capital to the small and little known enterprises, is often very high in other types of markets, and at times so out of range that it may prevent expansion. For large scale corporate organizations, capital can be raised in the securities market more freely and at lower cost than for smaller and little known enterprises.

> "The typical stock and bond broker differs from the investment house or securities middle man in that he has no dealings with the original issuer of securities. He stands in between the investor and the investment." (1)

1. Brokers - "A broker is an agent acting for his principal." (2) The broker does not take legal title to the securities. Stockbrokers buy and sell securities for their customers, and take their compensation for their services in commissions.

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1. H. Parker Willis, Investment Banking, 1936, p. 56
   Jules I. Bodgen
2. Hastings Lyon, Corporations and Their Financing, 1938, p. 803

While a dealer, in some states, must have his contracts involving $50.00 or more in writing, a broker can enforce oral contracts that he makes with his customers, because as an agent he can hold his principal for damages caused by his efforts to carry out the orders of the latter.

Stock exchange brokers divide into different classes. Some are strictly brokers, others are commission brokers or specialists. Commission brokers execute orders from the general investing and speculating public. Sometimes such brokers execute orders for each other at a reduced rate of commission. Orders which are placed for execution at prices which are away from the prevailing market customarily are turned over by brokers to other brokers who act as specialists in the particular stocks. These specialists maintain records, known as books, in which these orders are entered in the sequence received. The principle advantage which the specialist offers is providing a convenient concentration point for orders which otherwise could not be expediently handled by the regular brokers.

2. Dealers - A dealer buys and sells securities on his own account. They assume title of securities they buy and own those they sell.

Under the statute of frauds, a contract involving $50.00 or more must be in writing. Therefore, to hold those with whom he deals, he must have all contracts in written form.

These dealers furnish the marketing facilities for those securities which cannot be bought or sold on a brokerage exchange. The true dealer may purchase his securities from varying sources. He may buy them directly from an issuing corporation, from an underwriting firm or syndicate, or in the open market over a period of time. He carries these securities on his own account and at his own risk. As a result of the purchase of these securities, he hopes to sell them at a profit to investors.

> "He is a merchandiser in the true sense of that work. He takes risks, attempts positively to fit his wares to the apparent needs of his clients, and tries frankly to influence their decisions." (1)

The different class of dealers are notably floor traders and odd-lot dealers. A floor trader makes contracts on his own account on the floor of an Exchange. The floor trader has no commission to pay since he is executant of his own contracts and is a member of the Exchange.

Odd-lot dealers are those who execute orders, involving the purchase or sale of securities in lots less than the established unit of trading. For a great number of stocks on exchanges, 100 shares is the established minimum. Brokers who receive orders to buy or sell less than 100 shares place these orders with odd-lot dealers who fill them at prices slightly different from prevailing prices on 100-share lots.

1. Shaw, Livermore, Investment Principles & Analysis, 1938, p. 96

3. Stock Exchanges - Security exchanges are merely an aggregation of brokers who represent buyers and sellers of securities. These brokers meet and trade readily with one another at a single place.

The exchange's major function is that of bringing together buyers and sellers to a central floor upon which orders may be executed by the members.

Securities registered on stock exchanges must be in accordance with the regulations of the Securities and Exchange Commission, which possesses broad regulatory powers. Some securities may be admitted to unlisted trading privileges with the approval of the Commission. The practices and policies of the exchanges are also subject to governmental regulation.

The New York Stock Exchange may be regarded as an accepted standard of the other security exchanges and, therefore, an understanding of its functions and operations will clarify nearly all of the problems encountered by the other security exchanges.

The New York Stock Exchange consists of individual members who are allowed on the floor of the exchange for actual trading. These members may conduct their business in their individual capacity, or they may join in partnership with non-member partners to facilitate such business. These partnerships are then recognized as registered firms of the New York Stock Exchange and may either be general or limited in character.

The members of the New York Stock Exchange may be

classified into seven main groups. The commission broker, a member of the stock exchange, devotes his time and efforts to the executing of buying and selling orders for the account of outside customers. He serves as the chief channel through which orders to buy and sell listed securities from all over the world are brought to the floor of the New York Stock Exchange.

The second type of members of the exchange are brokers often termed as "two-dollar" brokers. The "two-dollar" broker is a broker whose customers are other brokers. His chief work is to assist other members of the exchange, mostly commission brokers. The name "two-dollar" broker arises from the fact that his fee for purchasing or selling 100 shares of a stock was formerly $2.00.

A third type of member is a floor trader. He acts in the capacity of a principal on his account. He buys and sells on his own account and risk rather than for others. He possesses several advantages over those who are non-members. Being directly on the floor of the exchange he comes into contact with the technical changes in the market first. Secondly, he does not have to pay any commissions. As a result he can afford to trade for small profits more easily than an outside trader. Often he buys his securities in the morning and sells at the end of the trading day so that he has no holdings to carry over night.

A fourth and very important group of members of the

various stock exchanges are the specialists. The specialist is an individual who may combine both the trader and broker functions but he concentrates in one or a group of securities in which he specializes. The specialists, owing to the possibilities of abuse that arise from this combination of broker and dealer functions, have been prohibited by the New York Stock Exchange to act as both broker and dealer, in the same transaction. Also the specialists may not give preference to transactions for his own account to that of his customers. The specialist's position arises out of the necessity of having some means for handling orders placed at specific prices other than the prevailing price. Orders placed at a definite price above or below market must be filed so that they may be executed whenever the market reaches the specified price. It is the function of the specialist to keep a record of all such orders and to execute them as it becomes possible to do so.

A fifth important group are the odd-lot dealers and brokers. In order to accommodate persons desiring to trade in less than 100 shares, odd-lot dealers and brokers have been established. The odd-lot dealer will buy and sell odd lots at any time within a given fraction of a point, usually one-eighth of the last actual transaction in that security floor.

A sixth class of stock exchange members are the bond brokers and dealers, who specialize in executing orders in bonds for the account of customers or for their own account.

A final category of members are the inactive members.

These persons have either retired from active participation in business or have purchased their seats chiefly to reduce commissions on their own operations rather than for others.

The securities which have been regularly admitted to trading privileges on these exchanges have traditionally been called listed issues in contrast to all other securities which are known as unlisted securities. The listing of a security gives it widespread recognition. The fact that it is listed recommends it to many people who insist upon having pledgeable and readily salable investments.

B. Individuals

Business enterprises often raise funds from stockholders, creditors, employees, customers or purchasers of the companies' products, officers, and personal friends of the manager.

The corporation may obtain needed capital from existing stockholders. It may be done at a very low cost and without much hardship providing the stockholders are satisfied with the company's present position. A complete absorption of the new issue by satisfied stockholders will lessen the chances of harm to the company from manipulation by speculative traders. Therefore new issues of securities are frequently offered to existing stockholders who have no inherent right to subscribe to additional stock. Bondholders may also be given the privilege of subscribing to a new issue of stock that has not been fully subscribed for by the old stockholders.

Another source may be the creditors of the company. This practice is usually limited to cases of readjustment and liquidation. In this case, the debt of the old company is settled by offering the stock of the new organization to the creditors of the old company.

A third means of securing capital is through employees. This is very rarely done because the employees are unable to furnish the capital needed. When it is done it is usually involved in a profit sharing scheme or is used to maintain goodwill within the company.

The fourth method which may supply or aid in the securing of funds for the corporations is through customers or in other words, the purchasers of the company's product. In the case of a newly organized company the appeal will be limited while in an established enterprise, the customers who are familiar with the business and its earning power, are good prospects.

The borrowing of funds from officers of the company is sometimes followed. This is usually done in times of emergency and is evidenced by either a note or an open account.

Personal friends of the officers or of management of the company may be appealed to in the case of a newly organized company or a small concern. This is often the only source for these concerns to obtain new fixed funds.

> "In conclusion of the various ways in which corporations may procure funds without resort to the capital market it may be noted that the

> choice between the use of internal and external sources of funds depends upon a number of factors. If the corporation shows a steady and satisfactory rate of return, it can very well raise its capital from within. On the other hand, if the earnings are meager or irregular, external sources of capital must be tapped." (1)

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1. Harold G. Moulton, Financial Organization & The Economic System, 1938, p. 145

V. The Role of Investment Banking

> "The middlemen in the fixed capital market are known as investment banks although that term in reality is a misnomer. The true investment bank is not at all a bank for it accepts no deposits, issues no currency, and does no lending that can be avoided. Its business is strictly that of underwriting and distributing new security issues to the public." (1)

The security issues involved are those of usually long-term issues running from one to fifty years and longer.

The capital used by the investment bankers, to carry out their work, is usually obtained from their own funds. If and when more funds are needed, short-term loans are made from commercial banks. The mark-up, the investment bankers put on their security issues, provide almost all of the income they receive.

The investment banker is very important in the American capital market. It is through these middlemen that the bulk of capital is raised. This is accomplished by gathering funds directly from investors or through intermediate institutions and directing its flow into the most promising channels. As a result large investment houses may be classed as wholesalers, retailers, and dealers, with some being the combination of both wholesaler and retailer. Securities are bought and sold, alone and with associates, both at wholesale and retail.

The investment banker is responsible to both the issuing company and to his investing clientele. In the case

1. James C. Dolley, Principles of Investment, 1940, p. 223

of the issuing company, the investment banker must be able to secure the necessary capital with soundness and safety. As to his clientele he must protect them from unsound investments. If issues are not listed, the liquidation of holdings can be done through the investment banker. However, the responsibility of the investment banker still holds true on securities that are listed or unlisted, in which he takes part. He must maintain a market on the securities until they have become somewhat seasoned, and in so doing he must exercise good judgment on them as long as they are outstanding.

A. Purchase of Securities

In the purchasing of a new security issue, the investment banker must be very careful. The bank must satisfy itself that the bonds or stocks to be purchased would be sound and desirable investment. The banker must also take into consideration the type of security most desired by the clientele, involving investors and business men. Obviously the purchasing department plays an important role in the investment bank.

> "It largely determines what security issues the house will attempt to distribute and in the case of originations, the terms of the issues and the prices at which the stocks or bonds are to be offered to the public. Efficient operations of the department means that the bank will handle sound securities properly priced which can be sold readily, thus binding up good will with the issuers and with the investing public." (1)

Proposals for new financing are received by investment bankers from many sources. Usually the large investment

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1. James C. Dolley, Principles of Investment, 1940, p. 232

houses receive far more than they can handle. When these proposals are received they are turned over to the buying department of the investment house for investigation.

In order to make a thorough investigation of the new offer, the purchasing department must make the use of the services of several technical experts. Among these experts may be men with broad outlook and wide experience.

> "This work will involve the employment of experts: accountants to audit and present statements that will accurately reflect the record and prospects of the company; engineers to examine the technical efficiency of operating plant and techniques; commercial researchers to study such matters as marketing, public relations, or labor policies, as they may be important; legal counsel to check on such matters as property titles, validity of patents, liability from possible law suits, legal soundness of various corporate acts, such as may be discovered by checking the corporate charter, by-laws, minutes of directors' meetings, and major contracts, and to prepare contracts incident to financing." (1)

Such an investigation into the issuing corporation yields a comparison with other companies in the same line of business. This data, along with the understanding of the condition of the market, provides the banker with knowledge from which to judge the advisability of the purchase.

Usually the last word in approving or rejecting the proposition is done by an investment committee, consisting of several or all the partners of the bank. However, they rely largely upon the investigational work of the purchase depart-

1. Harry G. Guthmann, Corporate Financial Policy, 1940, p. 366
   Herbert E. Dougall

ment, and their final decisions are usually based on the department recommendations.

Assuming that the proposition for the new issue is satisfactory and that the purchase of the securities has been undertaken, the activities of the buying department are then centered upon other securities. The disposing of the securities is then passed on to the selling department.

B. Sale of Securities

The general function of the sales department is to sell the securities purchased by the purchasing department. The clientele, to which the securities are sold, will determine the selling method. The investment banker may operate either as a wholesaler or retailer or as both, in order to dispose of the securities. If he acts as a wholesaler, he will dispose of the securities in large blocks whereas a retailer would take the task of reaching the general rank and file of the public.

The selling department is a well-arranged organization with a sales manager usually in charge. The staff of salesmen gather lists of customers and prospective customers, which they constantly try to enlarge. Direct visits are made to these customers with the hope that they may be induced to part with their money in exchange for the security. Therefore, well-trained and intelligent men must be on the staff, who can quickly acquire some understanding of the business of the corporation whose securities they are selling.

Along with the duty of the sales force to procure customers and make sales in order to distribute the issue, they also have much work that proceeds and follows the writing up of an order.

> "The securities salesman keeps in contact with buyers of investments. He informs himself of their investment purposes, needs and preferences and, from time to time, makes offerings of suitable securities. As sales are concluded, he sees to it that his clientele receive the various kinds of investment service which his house provides, and tries to leave nothing undone which will establish a mutually advantageous and lasting relationship between the customer and the house." (1)

Aid in the selling of the securities, which act as an auxiliary to the sales department, may come from advertising campaigns, circular letters etc.

> "During his selling campaign he usually inserts advertisements in the leading newspapers and financial magazines, giving the name of the issuing corporation; the size, title, status and provisions of the issue; a history of the company; dates of interest or dividend payment; the price and denominations in which the securities are offered; the name and address of the investment banker; and generally, a financial statement of the company's position." (2)

An offer cannot be made by this means of advertisement. A prospectus, which is filed with the Securities Exchange Commission, must accompany each offer by the investment banker.

1. Invest. Bankers Ass. of Am. Toward Careers in Finance, 1946
2. Charles W. Gerstenberg, Financial Organization and Management of Business, 1945, p. 365

> "Distributors of securities are extremely careful to see that every purchaser receives a copy of the prospectus, for the Securities Act of 1933 specifically provides that it is unlawful to use the mails or the instruments of transportation in interstate commerce to carry or transmit any security for the purpose of sale or delivery unless accompanied or preceded by a prospectus that meets the requirement of the Act." (1)

The salesman of an investment house, therefore, plays a very important part in securing capital for the financial executive and in helping the investor to employ his savings into sound investments. He furthers progress and directs capital into productive channels.

C. Trading in Issued Securities

> "The definition of the word trading means the process of trading, or bartering or of exchanging a commodity. In this case, the commodity is a bond and the department organized to carry on this work is the trading department." (2)

On many houses the trading department assumes substantial proportions and has an organization of specialized departments. An investment house may have only one trader, or it may have one for each class of securities.

The work of the department comprises many different types of activity. This activity may involve the need of purchasing originating issues during the period of distribution, when the market price of the new issue is lower than the distribution price. The trader will place a bid in the market to purchase all securities offered for sale below the invest-

1. Harry G. Guthmann & Dougall, Corporate Financial Policy, 1940 p. 365
2. Invest. Bankers Ass. of Amer., An Analysis of Investment Banking for Vocational Guidance, 1929, p. 47

ment house price. This is to prevent the weakening of the market so it will not interfere with the distribution of the securities to the general public. Thus, it is the function of the trading department to execute this order.

In cases where the house does not have certain issues which their clientele might want, the trader, under the direction of the salesmanager, will go out in the market and secure these securities. The primary object being to build customer good will.

Houses may accept marketable securities from customers in exchange or as partial payment for new securities. When this occurs it is the function of the trading department to dispose of these securities.

Sometimes it is more profitable to secure seasoned securities from an established market. The trading department will pick up these securities either in the market or from institutional investors and resell them at a price sufficient to make a profitable operation.

Another function, sometimes performed by the trading department is that of maintaining a secondary market for issues originally offered by the house.

D. Statistical Analysis of Securities

The size of the statistical department will vary in different houses. The main reason being the importance that is placed on the use of the department within the house. In some houses the statistical department is represented only by

a reference room with files and records available to all other departments, while in others it is an organized house,

> "when a new financing proposal first appears this department analyzes the company, the industry and the market for similar securities. It helps prepare registration statements and prospectuses, and aids the salesman in answering questions of prospective clients. It continually analyzes securities to guide the trading department; and finally it prepares special studies and circulars". (1)

The function of an organized statistical department is that of compiling and analyzing information for all the various departments of the house. Many contacts are established by the statistical department, in answering questions asked by the investors about their holdings. Some houses ask the investors to send their holdings in to be analyzed by the department. The list is studied and suggestions are made and if holdings are to be changed the suggestions usually pertain to the issues sponsored by the house.

The statistical department may aid the buying department in the securing of data pertaining to the problems involved in the purchasing of securities. If the buying department wishes data on a new business under consideration, a well organized statistical department will submit all the information available and needed.

> "For example, if the buying negotiations are concerned with an enterprise manufacturing automobile tires and other rubber goods, the department may look into markets for raw materials and

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1. H. Parker Willis, Investment Banking, 1936, p. 42
   Jules I. Bodgen

> finished product, other hazards of the rubber manufacturing industry, and hazards of the particular enterprise. Though the seller furnishes most of such information, the statistician can be corroborative and supplemental, and at the same time can be formulating the data into selling representations of facts." (1)

The accurate presentation of this data will help aid those making the final decision to determine whether to accept or reject or continue the investigation of the issue further.

The statistical department is valuable to the sales department. He may keep in contact with the developments affecting the market, and the particular securities the house is specializing in at the time in order to aid the salesman in answering questions from his customers. The statistician will follow the current financial news and study those securities held by their customers so that he can help the salesmen advise those customers.

If the trading department is active in an investment house, they need the information provided by the statistical department.

> "The statistical department's files are frequently very extensive and varied consisting of clippings, reports and circulars, annual reports of corporations, government bulletins, numerous special reports of various private agencies and other information relative to various corporations and governments, and of their securities." (2)

1. Hastings Lyon, Corporations and Their Financing, 1938, p. 463
2. Invest. Bankers Ass. of Amer., An Analysis of Investment Banking For Vocational Guidance, 1929, p. 49

The department often prepares compact data for circulars and advertisement.

E. Mechanical Handling of and Accounting For the Transactions of the Concern

The investment bank, in addition to the preceding departments, must maintain departments to provide for the mechanical handling of securities. Also, an accounting department is needed to keep the records of both security and money transactions.

One or more departments will be involved in the mechanical handling of securities. This will involve the custody and safekeeping of all securities. It will take care of the handling of coupons and redemptions. A mailing department and listing department may be needed also.

VI. Types of Financing

> "By financing is meant the actual acquiring of funds with which to procure the necessary property, tangible and intangible, and with which to perfect the organization, start operations, and keep them going until the business is on a self-supporting basis." (1)

These funds are secured through different instruments of financing by corporations. These instruments include secured and unsecured bonds, notes, and various classes of preferred and common stock. While these instruments of financing are few, there is wide flexibility and variety in their use.

Securities may be offered by a going concern in need of additional capital, or by a newly organized company. A newly organized company has the disadvantage of not being known, thus finding it difficult to impress prospective customers with its securities. A going concern has established itself in the money market, making it easier to secure the needed capital.

Borrowed capital may be for either long-term or short-term purposes. This type of financing places upon the company fixed charges at stated periods with the payment of the principal at the maturity of the loan.

> "If a corporation wishes to borrow money and the loan is large in amount it is usually effected by means of bonds. These are practically a formal

1. Charles W. Gerstenberg, Financial Organization & Management of Business, 1945, p. 41

> series of corporate notes occasionally unsecured but usually secured by some or all of the property of the corporation according to the term of the mortgage or as it is commonly termed, 'deed of trust'." (1)

Bonds may be used in place of stock to secure these funds because of the condition of the market. The corporation's stock may not readily sell and if so, only at a disadvantageously low price.

Even if stock could be sold, bonds may be preferable for the following reasons:

> "1. To avoid sharing the voting privilege
> 2. To enlarge the possible sources of funds
> 3. To lower the cost of funds
> 4. Trading on the equity." (2)

If a new issue of stock is offered, the existing stockholders, in order to retain their proportion of voting, will have to buy accordingly. However, if bonds are issued the stockholder will continue to have the same voting strength as before. With the issuance of bonds the corporation acquires investors who otherwise would not invest in stocks. Often the sale of bonds can be accomplished much more cheaply than the sale of stock.

The general objection to bonds is the hazard of solvency. This is particularly true of industrial concerns. However, this risk is assumed when the issuance of bonds is less expensive than that of stock.

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1. Hugh R. Conyington, Financing an Enterprise, Vol. 2, 1921, p. 293
2. Harry Guthmann, Corporate Financial Policy, 1940, p. 113
   Herbert E. Dougall

In addition to the bond there is prepared and issued an indenture. This indenture is a legal instrument which is executed by the parties to the contract. In order to eliminate the embodying of all terms in each bond, a trust company is named in the indenture, to see that all promises are fulfilled. This makes the trustee the legal representative of the bondholder.

The indenture will contain a number of clauses usually found in such an instrument plus special features covering the interests of the bondholders.

A. First Mortgage Bonds

> "A mortgage may be defined as a deed absolute in form, but subject to defeasance, given to secure the performance of some act on the part of the mortgagor, usually his repayment of a loan made by the mortgagee at the time of execution and delivery of the mortgage." (1)

In the case of a mortgage bond, a specific piece of property is pledged for the holder of the bonds of the issuing company. If the company should default in making either the interest payments at the stated dates or in repayment of the principle on maturity, the bondholders, have the right to take action against the issuing company.

There are many different types of bonds to which the term "mortgage" is affixed. However, in the true sense, such bonds are a first mortgage on only a part of the company's

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1. Ralph Eastman Badger, Badger on Investment Principles and Practices, 1928, p. 143

assets. A few which are not in the full sense first mortgage bonds, are refunding bonds, general mortgage bonds, and consolidated mortgage bonds.

> "How first mortgage bonds are issued, the steps in the process of making a bond issue:
> 1. The party chiefly interested in erecting an office building, for instance, whom we shall call the borrower, selects a location and sketches roughly the nature of the building and the approximate amount of his own money he wants to put into the enterprise, and the amount he wants to borrow to complete the building.
>
> 2. The borrower submits this project to the investment banker, who studies the proposal from the standpoint of property values, probable income and chances of lasting success for the enterprise. This usually involves a thorough investigation of such factors as the location, with respect to shifting population centers, etc., the proportion of the investment to be made by the borrower to the amount he seeks to borrow, the market, the business situation, and many other elements. In making this investigation the investment banker employs the services of competent disinterested appraisers, architects, engineers, contractors, attorneys, and experts on real estate values and rental conditions in the locality where it is proposed to erect the building.
>
> The investment banker makes this investigation not as the agent of the borrower but rather as the agent of the people who are later to loan their money to the borrower, for only with this critical attitude can he discover possible faults in the plan which might later cause its success to be impaired.
>
> At the end of this examination the investment banker tells the borrower how much money he can reasonably expect to borrow and on what terms this capital can be procured.
>
> 3. If the investment banker's report is received with favor the borrower authorizes the banker to proceed with making the loan and preparing an issue of bonds to be signed by the borrower rep-

> resenting his indebtedness to the various individuals who, by purchasing these bonds, provide money for the loans whose proceeds will complete the building.
>
> 4. The investment banker arranges the details of the transaction, supervises the terms of the trust deed by which the bonds are secured, sees that a suitable trustee is appointed to act for the bondholders, has all the necessary documents prepared in correct legal form, sees that titles are clear, and arranges for the sale of the bonds.
>
> 5. At the time agreed upon the investment banker provides the funds needed by the borrower, and in turn is reimbursed through the proceeds of the sale of the bonds to investors.
>
> 6. It will be seen that the success of the investment banker depends largely upon his judgment in selecting sound issues and his ability to sell these issues of bonds in a comparatively short time to the customers whose confidence he has won through long years of fair dealing. This confidence of investors is after all the investment banker's greatest asset, and the longer he is in business the more careful he will be to protect this asset of good will by furthering the best interests of his customers." (1)

B. Debenture Bonds

Debenture bonds are "those securities which are not secured by any specific pledge of property". (2) They may be spoken of as plain bonds or general straight bonds in that they rest upon the general credit of the company. They have no direct lien on the company's assets. They are somewhat like promissory notes backed by the issuing company's general credit.

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1. What Your Investment Banker Does For You, 1925, pgs. 3-7
2. William H. Husband, Modern Corporation Finance, 1942, p. 152
   James C. Dockeray

Debenture bonds are especially appealing in corporate financing because of the absence of a direct lien by the bondholders. Furthermore, debenture bonds give management more freedom and permit the sale of bonds with prior liens in times of emergency. There can be no foreclosure by the bondholders in case of default by the company in interest or principal payments, because there is nothing to foreclose, but of course some suitable agreement must be reached with the debenture holders.

C. Convertible Bonds

Corporations, when in need of funds, can obtain the highest price possible for their issue of securities by issuing convertible bonds. It is a common practice for corporations issuing bonds, to have some of them contain the convertible feature. The convertible feature is very attractive to certain class of investors, who otherwise would not invest their savings. It makes its strongest appeal to the speculative type of investor.

> "Any security that can be exchanged for another type of security issued by the same corporation is a convertible security. A convertible bond therefore, is a bond which may be exchanged for another security, ordinarily the stock of the issuing company." (1)

The conversion privilege is usually stated in the bond contract leaving the conversion privilege optional with the bondholder.

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1. Avard Longley Bishop, Financing of Business Enterprises, 1929 p. 267

Often a company cannot offer, through either its stock or bonds the three factors desired by purchasers: adequate income, lack of risk, control. However, the convertible bond seems to come the nearest to these features than any other type of security.

> "When an investor buys a bond convertible into stock, he gets (1) the certainty of income characteristic of the bond; (2) the preferred position of a creditor if the company should fail; and (3) the chance of sharing in the profits if the company becomes prosperous, which chance is the peculiar privilege of the stockholders." (1)

In the case of industrial concerns, convertible bonds are regarded as a temporary security, the stock into which the bond is to be converted is considered the final security. When the concern issues the bonds, the stock to which it may be converted is authorized in order to assure a sufficient amount of unissued stock when conversion takes place.

The conversion privilege provides many compensating benefits to the issuing corporation. Usually the corporation can obtain funds at a lower interest rate. The conversion will reduce the fixed charges of the concern when the retirement takes place. Also, when the popularity of stock is low on the market, the prices of the bond will usually be equivalent to that of stocks in good times.

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1. Charles W. Gerstenberg, Financial Organization & Management of Business, 1945, p. 246

> "The advantage of convertible bonds over stock is that, in a declining market, the bonds will not fall below their investment value as straight bonds, whereas the stock, not having that intrinsic strength, may fall to an extremely low level. In an advancing market, the bonds will advance fully proportionate to the stock after the conversion parity has been passed." (1)

D. Income Bonds

While income bonds are bonds in name, and at law, they somewhat follow the characteristics of preferred stocks. The income bond in most cases is a promise to pay the holder a definite sum of money at a specified time.

The income bond is an interest-bearing security. The interest is paid the bondholders when it is earned by the corporation. It may be cumulative or non-cumulative. Usually the investment contract of the bond provides that no dividends shall be paid to stockholders until the bondholders, for the same period, have received their full interest.

Unlike stock, these bonds have a maturity date. They may also have a mortgage lien which is usually a junior lien. The only advantage of this is that in case of default in principle at maturity or in the case of insolvency, the mortgage lien will determine its rank among the creditors and those of junior issues.

> "Perhaps the chief difference in practice between the income bond and the preferred stock is that the indenture of the former is usually drawn so strictly that directors are required to declare an interest payment whenever earnings

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1. David F. Jordan, Jordan on Investments, 1946, p. 31

> are shown, while the declaration of preferred dividends lies within the discretion of the board." (1)

This type of bond is usually offered in time of failure and reorganization. The corporation wishes to make up for the past losses and therefore permit the investors to share in future gains. Thus, such bonds have been called adjustment and preference bonds.

E. Direct Loans by Insurance Company

The insurance companies are leaders in this field. Their loans are made direct to industrial concerns on improved non-industrial real estate and on industrial property. The restrictions involved will vary depending upon the type of business.

To interest the life insurance companies, the loan will have to be a sizable amount and for a period of time from five to fifteen years or longer.

> "To be eligible for one of these loans, the value of your plant and machinery, land and buildings, must be at least double the amount to be borrowed. Your net earnings for the past five years must average one and one-half times the annual requirements of the loan, which include both interest and a reduction of the principle. Furthermore, the net earnings for the past twelve months must not fall below one and one-half times the annual requirements. Net earnings, as defined by insurance companies, consist of the amount left over after deducting taxes and ordinary depreciation from net operating profits. These deductions do not include interest on mortgages, nor any

1. William Hurd Hillyer, Keys to Busines Cash, 1942, p. 16

> other kind of outlay which will be replaced by the insurance loan." (1)

F. Direct Loans from College Endowment Funds

Colleges found it necessary to seek for greater income for two reasons: (1) The low rate of return from investment bonds in their endowment funds. (2) Mounting expenses due to salary increases and material costs. Thus, college endowment fund managers were forced to seek other means of income without over-concentrating in preferred and common stocks.

At the same time, certain industries found it necessary to arrive at a quick way of getting working capital without going into debt. A happy common meeting ground was found. The corporations were able to sell some of their property to college endowment funds giving the colleges an excellent investment in buildings. These buildings carried attractive long-term leases providing steady income. This was done by certain department stores and variety chains. Thus, their store buildings were owned by a single college endowment fund. The colleges were assured of above average income from their endowment fund investments. Furthermore, many of these leases are on a percentage of gross sales. This percentage basis gives the college endowment fund a chance for more income. It also might be said that very few colleges would foreclose on such property. This gives the corporation a chance to work out of any tight financial plight.

1. William Hurd Hillyer, Keys To Busines Cash, 1942, p. 16

VII. Types of Financing - Continued

> "Financing by means of stock is simply arranging to operate a business on permanently owned capital invested by interested parties who, by virtue of their investments, become the owners of the business." (1)

When the company sells stock, the stockholders are given certificates of stock designating the number of shares purchased. This is evidence of the purchasers ownership in the company.

There are many important features affecting the corporation involved in issuing stock. The sale of stock provides the corporation with permanently owned capital, which can be used at the discretion of management. Such stocks as common stock with or without par value, or voting or non-voting may be the type of stock the corporation may wish to issue under certain circumstances; whereas, other corporations may issue preferred stocks with or without rights of preference to assets, cumulative or non-cumulative, first or second preferred, non-participating or participating. These stocks represent only a few of the many classes of stock which have been developed.

The different types of stocks have various characteristics and will interest different types of investors. Those investors who are interested chiefly in safety and steady income will choose only those stocks of high investment rating.

1. Joseph Howard Bonneville, Organizing & Financing Business
   Lloyd Ellis Dewey 1945, p. 87

Investors who are interested in greater income, possibly with some speculative feature, will seek a lower grade of stock, such as a second preferred. Finally, there are those who want mainly larger price appreciation. They pick the more speculative type of common stock.

A. Preferred Stock

> "Preferred stock is stock which, while it possesses the same rights and privileges as common stock, has in addition certain more or less valuable and desirable preferences." (1)

This class of stock, like common, evidences ownership and has the right to participate in the earnings and management of the corporation.

Preferred stocks are purchased mostly by individuals, the reason being that preferred stocks in many cases are not permissable for purchase by regulated institutional investors. Hillyer says,

> "for a preferred stock issue, regardless of size, the prime requisite is a fine record of net earnings. Unless you can show, for the past three to five years net earnings amounting to at least double the dividend requirements on the proposed issue, you should not consider this method". (2)

There are various reasons for the issuance and existence of preferred stocks in American finance. The issuance should be justifiable, for the cost is comparatively high through this channel. The following are the reasons stated

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1. Joseph Howard Bonneville, Organizing & Financing Business
   Lloyd Ellis Dewey 1945, p. 89
2. William Hurd Hillyer, Keys to Business Cash, 1942, p. 21

by Husband and Dockeray,

> "1. Necessity - a substitute for bonds. Financial conditions may preclude the issuance of high-grade bonds, but may be satisfactory for the sale of preferred stock. More specifically, the earnings of a particular company may not be sufficiently stable to meet the fixed charges on bonds, but the average return may justify the use of preferred stock.
>
> 2. Reorganization issue. Preferred stock, particularly of the non-cumulative variety, has been utilized as a means of satisfying junior bondholders' demands in a reorganization program.
>
> 3. Protection of control. Preferred stock is not only a convenient alternative for the raising of capital but it may also be favored for reasons of control. Preferred stock usually has limited voting rights, but seldom has authority to vote on operating policies. By using stock of the preferred type, controlling interests may continue their positions without further investment.
>
> 4. Market conditions. Money market conditions occasionally make it desirable to float preferred stock in preference to common stock. (1)

One of the main disadvantages from the corporation's standpoint is that dividends payable on preferred stock are higher than the interest payable on a bond issue. If the dividends on the preferred stock of a corporation are not paid within a certain time after they are due, the preferred stockholders acquire voting rights to elect a certain number of directors and thus participate in the management of the corporation.

The preferred stockholders have no direct lien on the assets of the corporation. Only after all prior claims

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1. William H. Husband, Modern Corporation Finance, 1942, p. 74
   James C. Dockeray

have been paid will the preferred stockholders receive a payment in liquidation.

1. First and Second Preferred Stocks - Preferred stocks may be classified, in some respects like bonds, as to their priority. Corporations may issue first and/or second preferred stocks. The first preferred stock has a claim on dividends and assets in case of dissolution. The second preferred stock coming next is a junior issue to the first preferred.

Being preferred as to dividends means that if any stock is to receive dividends out of the earnings, the stock designated as first preferred will receive the payment before any other class of preferred stock. Being preferred as to assets means that in case of dissolution of the corporation the first preferred holders will participate first, with the second preferred coming next, and so on.

2. Convertible Preferred - A class of stock issued by a corporation may be one with the convertible feature. Such stock may permit the holder to convert his stock into common. Such conversion is always at the option of the stockholder. The certificate of incorporation may state that the conversion be done within a specified time, but within this time the stockholder may convert at his pleasure.

As in the case of convertible bonds, where they may be convertible into common stocks, so may the preferred stock have a conversion feature. To the investor the convertible preferred is advantageous, giving the investor preference as

to dividends when earnings are low and when the corporation becomes successful, the conversion feature allows the holder to convert his stock into common in order to participate in the large returns.

After the conversion has taken place the stockholder has given up any right to reclaim his original security and therefore cannot reconvert the stock to what he had before.

Since this type of stock favors the investor, it is unfavorable to the corporation. The reason being that the earnings have to be spread over a greater number of shares, due to the issuing of stock to the converting security holders. Therefore, it is usually issued by those corporations with weak credit standing at the time of financing.

3. Participating Preferred - Participating preferred stock gives the holder the right to participate in the earnings of the company over and above the specified rate of dividend. This, of course, is valuable to the preferred investor, but to the common investment holder it reduces his chance of extra dividends.

This type of stock is ideal for the investor. The holder has priority over the common stock and in times of unusual earnings, he is allowed to participate further. Such as is the case where the holder participates in earnings after both his preferred stock and the common stock have received stated dividends.

"The participating preferred stock retains its prefer-

ential position while enjoying all the fruits of success, if any". (1)

As in the case of convertible preferred stock, so it is with participating preferred stock, the corporation finds it to be a non-desirable issue. The desirable feature from the standpoint of the corporation in the issuance of such a security is to offset the low credit of the company.

Not all securities such as participating preferred are issued by companies of weak credit standing. These stocks may be issued because of the newness of the corporation and because of the prevailing market conditions at the time of issuance.

> "The methods of participation are generally known as participating simply, participating immediately, participating specially.
>
> Simple participating or ordinary participation is an arrangement whereby preferred stock is the first, up to the specified rate, to receive its dividends; after that, common stock will be paid dividends as far as possible up to and including the same rate that the preferred has received; and if, after having paid both the preferred and the common the same rate of dividend, thereby anything left of the total amount declared as dividend, it is shared or participated in by both the preferred and common alike, just as though they were only one class.
>
> Participating immediately is when the arrangement for apportioning the dividend among the classes of stock provides that the preferred stock is the first to receive dividends up to the specified rate and that immediately thereafter, without first giving the common stock a dividend payment at the same rate, all the remainder of the dividend money is allotted to all stock alike, regardless of

1. Ralph Eastman Badger, Investment Principles & Practices, 1941
   Harry G. Guthmann p. 224

> whether it be preferred or common.
>
> Participating specially - Any and all methods of participation other than simple participation and immediate participation are generally grouped under the name special participation.
>
> The number of methods of participation is limited only by the ingenuity of the company organizers. It is possible for instance to have the preferred get 6 per cent, then the common 6 per cent, then the preferred all the remainders; or the preferred 6 per cent, then the common 6 per cent, then the preferred 4 per cent, then the common 2 per cent, then the remainder pro rata." (1)

4. Income Preferred. This type of preferred stock is only one step removed from a common stock. It is used by corporations which do not have the highest type of credit rating and also by new corporations. Many times it also evolves from a recapitalization or refinancing.

In most cases there is an upper limit as to the amount of the total dividend payable in any one year. For example, the stock might be called as 5% income preferred. This means that if 5% is earned on the stock, the owners of the stock would expect to receive the full 5% as a dividend. If, as for instance, earnings fall off in a year of declining business volume, then maybe only 1% would be earned on the income preferred. In such an event, only 1% would be payable as a dividend to the owners of the stock. Income preferred stocks usually have call features the same as regular preferred stocks. Thus, in short, it is really only in the dividend feature, that

1. Joseph Howard Bonneville, Organizing & Financing Business,
   Lloyd Ellis Dewey 1945, p. 90

B. Common Stock

> "Common stockholders are the residual claimants against the assets and income of the corporation." (1)

Common stockholders are entitled to all assets that are left after all prior claims have been satisfied.

> "In many ways, common stock constitutes an ideal source of funds for the corporation. The reasons for this may be as follows:
> 1. Absence of fixed charges. Common stock is admirably adapted to meet changing business conditions. If business is depressed and the earnings of a corporation are lowered materially, sound financial policy may require the passing of dividends. Default of interest on bonds would precipitate failure, but the omission of dividends has no such serious consequences. As a result, stocks provide a cushion of safety against temporary unfavorable developments.
>
> 2. Improved credit standing. Extensive use of common stock to raise capital also improves the credit position of the corporation. Automatically the enlargement ofthe residual equity increases the base of credit operation.
>
> 3. More economical financing. On occasions it is cheaper to finance with common stock than with b onds." (2)

The issuance of common stock by corporations may not be desirable due to various circumstances. The market for common stocks may be unduly depressed at the time. There are a large number of investors who will not buy common stocks at certain times during the business cycle regardless of the yield or earnings. Also, the sale of the stock may be restricted to

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1. Henry E. Hoagland, Corporation Finance, 1933, p. 39
2. William H. Husband, Modern Corporation Finance, 1942, p. 50
   James C. Dockeray

a local area because of the restricted area or market served by the corporation. If more common stock is issued, those who have control might not have sufficient funds to purchase enough stock to maintain their control. Furthermore, the increase in common stock might temporarily reduce the earnings per share down to only a nominal amount.

C. Short Term Borrowing

While every corporation must have stock and must do its fundamental financing by means of the owned funds contributed by the stockholders, there is practically no corporation which finances by stock exclusively. Every business finds it necessary to borrow occasionally for short periods.

> "There is no method of raising funds which is cheaper than borrowing. A corporation should borrow as much as it can within the limits of safety, if it can use this capital to advantage." (1)

Short-term financing is represented chiefly by short time bank loans, commercial paper, and acceptances. While the methods of financing by short-term are few, they provide flexibility and wide variation.

"The great advantages of borrowing are economy and convenience." (2) When the return on borrowed capital becomes greater than the interest, borrowed capital becomes profitable. Thus the owners receive a higher return than when borrowing is not resorted to.

1. Robert H. Montgomery, Financial Handbook, 1925, p. 568
2. Ibid p. 568

Many specialists in this field advise borrowing for short-term requirements only for the purpose of meeting emergency or seasonal needs or of taking advantage of cash discounts.

Borrowing for short-term requirements can be done by many different methods which will be seen in the following discussion.

1. Unsecured Bank Loans - One of the most common methods is the discounting of the concern's promissory note or notes at one or more banks. These are unsecured demand loans or secured time loans with a definite date of maturity ranging from one month to one year.

> "It has been variously estimated that from 60 to 70 percent of bank loans are unsecured; no collateral is deposited with the banks; and such loans are made with no other security than the general credit of the borrower, which is pledged when the promissory note is signed." (1)

Banks have found that loans can be made safely without security, when the proper investigation has been made.

These notes are a direct obligation of the company. This method of financing short-term requirements is usually the most satisfactory when the firm's financial condition is sound and the character of management is high.

> "Good banking is not pawnbroking or collateral lending but is the recognition or cashing of current titles based on values growing out of ordinary trade and unaccompanied by detailed or

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1. Joseph Howard Bonneville, Organizing & Financing Business, 1945, p. 259

particular evidence of ownership of goods." (1)

2. Sale of Promissory Notes - Sometimes companies receive promissory notes from their customers in settlement of accounts, whereby if funds are needed, such notes may be endorsed and discounted with the bank, the company receiving cash or credit for the face value of the note less the discount.

These notes are usually unsecured and recognized by the term commercial paper.

3. Discounting Trade and Banker's Acceptance -

> "The trade acceptance has been defined as a time draft drawn by the seller of merchandise on the buyer for the purchase price of the goods and accepted by the buyer, payable on a certain date, at a certain place designated on its face." (2)

It is generally used where terms are medium to long, with the total amount considerably large.

> "The customary procedure in connection with the use of the trade acceptance is as follows: When rendering an invoice for the purchase of merchandise, if the amount is reasonably large, the seller will accompany the invoice with a trade acceptance form filled out for the amount due, or if the buyer purchases several bills of small amounts during the month, the seller will accompany the monthly statement with a trade acceptance form filled out for the total amount due. The buyer has the option of either paying the bill, deducting the cash discount if such is allowed, or he may accept the trade acceptance by writing across its face the date and the words 'accepted payable at...' signing it, and returning it to the seller." (3)

1. Joseph Howard Bonneville, Organizing & Financing Business, Lloyd Ellis Dewey 1945, p. 259
2. W. J. Donald, Handbood of Bus. Administration, 1931, p. 455
3. Ibid p. 455-456

Now if the company is in need of funds, instead of waiting for the money, they may discount a number of trade acceptances at the bank. They may also discount them to commercial houses or brokers. As a result the company may realize on funds which otherwise would have been tied up in the book accounts.

> "The bank acceptance is merely a time draft drawn against a bank and accepted by the latter by stamping the word 'accepted', the date, and the signature of an officer across the face of the draft." (1)

4. Loans Secured by Stock Market Collateral - If a corporation is in need of more funds than available to them by banks on an unsecured basis, they may obtain these funds by giving stocks for collateral. These concerns have in their portfolios, stocks and bonds, which they can persuade banks to take as collateral for a loan above that which they are entitled to on an unsecured basis.

5. Commodity Loans - At times funds may be obtained by pledging commodities as collateral for loans. Therefore, corporations can obtain larger loans than its own financial standing and credit rating would otherwise entitle it on an unsecured basis.

The goods used as collateral are placed in a public warehouse, with the owner obtaining warehouse receipts covering these items. The owner of these receipts may then borrow

1. W. J. Donald, Handbook of Bus. Administration, 1931, p. 458

from his bank on his promissory note secured by the warehouse receipts.

6. Assignment of Receivables - This method is used to postpone financial insolvency. The necessary funds are secured by selling the company's open book accounts.

These loans are secured mostly from finance companies, who charge a higher rate of interest than the customary rate of that of commercial banks.

7. Miscellaneous Methods of Short-term Borrowing - Installment transactions is another method also carried out through finance companies.

> "Other methods of raising short-term funds which are occasionally employed are the following: loans secured by real estate and other property, loans on insurance policies, and character loans." (1)

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1. W. J. Donald, Handbook of Bus. Administration, 1931,p. 461

VIII. Case History of a Recent Financing by Investment Bankers

Main street, U.S.A. is really the financial backbone of going industrial concerns. People in all walks of life purchase stocks which provide money to build new plants, develop new processes and create new jobs.

The following is a case of how a recent Dow Stock issue was planned and sold. On July 30, 1947, an important business transaction was reported in the financial pages of the nation's newspapers.

The announcement was that the Dow Chemical Company, of Midland, Michigan, had increased its working capital by the sale of some 400,000 shares of new stock. This transaction was put down in record books as one of the fastest sales of stock.

That same day a New York investment banking firm, Smith, Barney and Co., handed over a check for $40,200,000.00 to Earl W. Bennett, vice-president and treasurer of the Dow Company. The whole affair took place without a fanfare, much in the same manner as a merchant would accept a check from a purchaser.

Thus the disposing of the 400,000 shares was the responsibility of the investment bankers. It was their function to dispose of these stocks to investors throughout the country. As far as Mr. Bennett was concerned he had the money and could thus proceed with his plans for the future. The money meant

plant additions, new jobs, new products developed and put into production.

In addition, the money represented thousands of new stockholders in the Dow Chemical Company. These investors were persons in towns, cities and farms all over the nation, who put their savings in Dow stock because of its excellent future.

This transaction was not brought about by borrowing or through a banker's loan, but through a simple operation by the investment firm. This operation was completed by Dow's receiving a forty million dollar check.

Investment banking concerns simply purchase securities from corporations like Dow and then sell them to the public. They are aware of the market conditions and maintain contacts throughout the financial world.

The purchase of a stock issue requires the middleman or underwriter to perform certain functions. He must raise as much money for the company as needed by purchasing the security at a fair price. He must determine at what price the security will be attractive to investors. He must also assume the responsibility of purchasing a security, at a guaranteed fixed price to the company.

The acquisition of $40,200,000 by Dow in July probably got under way six months earlier. At that time the Dow Chemical Company approached the Investment banker and told him that it needed funds to carry out some plans.

This resulted in determining the best method of raising the money. Also a comprehensive study of the general industrial picutre and Dow's position within the industry had to be prepared.

At the time it was advisable to avoid added debt through borrowing which could have been done from either banks or insurance companies. Since it was a sound business policy to avoid too large a debt, it was decided that the issuance of new stock would best serve Dow's needs. The company had many types of stocks to choose from, but in the preceding years the fashion had been to issue a preferred stock that is convertible into common stock.

It was finally decided by Dow and the underwriter, after thorough investigation into the situation, that Dow would issue 400,000 shares of convertible preferred stock. The prime underwiriter together with other underwriters bought the shares at $100.50 a share. Thus, Dow received $40,200,000 on the transactions. The underwriters then sold the stock to the public at $102.50 a share.

This $2.00 a share spread had to cover distribution and selling costs, legal fees, advertising, printing and other numerous expenses. Dealers were to receive a commission of $1.00 a share on any sales and a further 25¢ to dealers who resold to brokers.

However, much detail work had to be done before the Dow stock could be placed on the market. A registration state-

ment had to be filed with the Securities and Exchange Commission. Necessary contracts and a Prospectus, outlining the company's history and earnings record had to be prepared.

The standing of the Dow Company in the chemical industry practically assured ready sale of the stock to the investing public.

Prospective purchasers were from all walks of life: farmers, merchants, doctors, business men, and so on. Also the risk of distribution was spread among these 136 underwriters.

The date of sale to the public was set for July 23. At this time the entire issue of 400,000 shares was purchased in a matter of two hours.

The corporation usually receives payment four or five days after the stock has been marketed. During this time the underwriters send in their checks to the prime underwriter in payment for the shares they have underwritten. Thus it was on July 30 that Mr. Bennett was handed the $40,200,000.00 check.

Thus on July 30, the Dow Chemical Company received this substantial sum with which to expand and diversify.

The months of planning and preparation that preceded the actual sale will fade in the background while the benefits it achieved will remain and grow in importance.

IX. Conclusion - Future Trends of Financing

A. Importance of the Business Cycle

Financial management must recognize with alertness the conditions occuring in busines cycles. They must also recognize the direction and probable duration of such changes.

In connection with the cyclical movements of business, the businessman must determine his buying and selling policies in relation to the need for funds. He must determine at which time the funds should be raised and the kinds of obligations to incur at different stages of the cycle. Another problem in connection with cycles is that of credit and collection policies.

When business is booming and people are optimistic, the corporations find it the best time to raise funds. This usually occurs toward the end of the period of prosperity. However, at the time, it is wise to put on the brakes.

The following procedure might be used by corporations in taking advantage of the business cycle. With beginning of the period of depression, the interest rates are low and the banks have ample cash for loans. At this time the business man is usually making plans for sales and inventories. Also, plans for acquiring new equipment are made in order to capitalize on the coming period of activity. At this time prices are low and business is dull in the construction field. Contracts for equipment and construction can therefore be made to advantage. Financial management can borrow and buy on credit with-

out much trouble in this period of expansion. As business begins to increase in activity with the period of prosperity coming into effect, the management may sell their securities at good prices and may pay off their loans. With this capital, the corporation is then in a strong position to start the next cycle with good credit standing on which the procedure is predicated.

The issuance of securities should be considered when analyzing cycles. At the beginning of a long period of rising prices, the company may sell long-term low interest bearing bonds. At the beginning of a long period of price decline, bonds should be made short-term, or redeemable, or the company should sell stock.

The same may be considered for major and minor cycles of business activity. If funds are to be raised at the end of depression and at the beginning of expansion through the sale of securities, bonds or short-term notes may be used. These may be refunded into stock as the business cycle enters the period of prosperity and many companies start increasing their dividend payments. If the bonds are made convertible, this refunding takes place automatically with the increase in the dividend rate which enhances the market price of the stock.

B. Future Taxation Trends

All corporations will be affected by the general overhauling of tax laws that is being planned.

Broad new tax cuts have already been passed and other

changes are being proposed and considered by the House Ways and Means Committee for future action.

Corporations received a tax cut that started on 1946 income with repeal of the wartime excess-profits tax and a slight decrease in normal rates.

The feeling is that business income is almost sure to gain some tax relief in the future. Cuts in business taxes are urged in order to expand existing business and to start new enterprises. It is a means to increasing incentive.

There is some support for Congress to wipe out all corporate taxes and have the stockholders pay individual income taxes on distributed corporate earnings.

Thus double taxation of corporate earnings is being considered in light that it be reduced or eliminated in some other way. Under present law the corporate dividends are taxed twice. Once when they are reported as profits by the corporation and again when stockholders report dividends as individual income. The Treasury proposes to allow corporations to take a tax deduction for the dividends they declare. Another is to give stockholders credit for the tax paid by corporations in which they hold shares.

Depreciation allowances are to be considered in order to stimulate business expansion and improvements. Under present laws, tax allowances for depreciation are based on original costs of business equipment. It is felt that depreciation allowances are not enough to cover the cost of replacing

equipment at present high prices.

One of Congress's toughest tax problems is that of capital gains tax. There are demands both to tighten this tax and to wipe it out.

Members of Congress and the Treasury are favoring the revision of the present stock-option ruling. The Treasury now holds that the difference between the market value of a stock and the price at which it is sold to a company officer or employee under a stock option is taxable income. There is hope that a revision will be made of this ruling.

Consideration will be given to the tightening of the present law involving estate and gift taxes.

As can be seen by the preceding examples, the tax trend is downward. This is expected to continue for several years.

Congress feels that the time has come to start making the changes that tax authorities have been talking about for years. The tax revision program can be undertaken more readily in a period of declining taxes than in a period of increasing taxes.

This trend towards tax reduction should enable corporations to obtain new funds more readily and help investment bankers raise such funds quicker.

C. Possible Government Control of Interest Rates

For the first time in history, the Federal Government, during World War II attempted to control the movements

of interest rates. In prior periods of national emergency either due to war or depression, pressure was brought to bear on interest rates, but no direct control was attempted.

The success of the control movement during World War II was clearly evident. The Federal Government was practically forced into such rigid control by the vast amount of money it needed to borrow to finance the tremendous armament program.

Once control is obtained it is very difficult for the Government to let go and it is equally hard for private banking to again take over. From the action on the part of the government since the end of World War II, it rather looks as though the Government does not want to release control of interest rates. Huge sums of refinancing must be done over coming years with United States Government bonds. With this financing facing government fiscal planners, making money rates seek their own normal level might be very embarrassing on the part of the government and cause grave concern to the banking fraternity.

In spite of all this, it looks now as though the Investment Banking business must plan to operate under more or less control of interest rates on the part of the government. This could last for as long as ten years.

This means, that on future financing of American industry somewhat lower interest rates will prevail than would ordinarily exist due to this government influence and control.

Higher interest rates are bound to come. In fact, they have already started to edge higher with definite assistance being given by the government. Many feel that a top of around 3% may have to be paid before many years roll by for longer term government bond issues. This means that investment bankers, may well be issuing industrial bonds to yield almost 5% and public utility issues from 4% to 4½%. What railroad issues will come out will probably be on a 4½% to 5% basis, depending largely of course on the nature of the issue and the railroad involved.

D. Popularity Trends

The stock prices of today are staying down while everything else continues its spiral upward. In the midst of the greatest boom in United States history, the stock market stayed in the doldrums for many months after September, 1946.

Records have been smashed in the past year. Profits are the greatest on record and dividend payments in 1947 set a new high level. More products are being produced and sold than ever before. But people with money are cautious about placing their funds in corporate stocks.

The corporations are in need of very large amounts of new capital to expand production and to improve present facilities for doing business.

A major source of this capital is through the sale of stock, which at present is very difficult to tap. The Securities Exchange Commission show that $7,000,000,000 in

corporate stock issues, which were filed for approval, have been withdrawn because of unfavorable market conditions. Others that were being planned, were not even submitted.

Total issues of new securities in 1947 amounted to $6,700,000,000, biggest year since 1929 and $2,300,000,000 more than securities issued in 1946. As is seen, capital has not been exhausted, but it also can be seen that capital is not anxious to take today's risks in common stock.

Stocks issued by corporations amounted to $1,200,000,000 in 1947, a decline of $300,000,000 from that of 1946. Thus, financing by corporations through stocks is becoming less and less easy in that investors are preferring securities that carry specific and fixed promises to pay over issues whose dividends depend upon profits. Stocks today are selling at prices that yield 5.4 per cent. Even with this yield, many stocks fail to attract buyers. As can be seen, inflation does not hold true with the stock market.

Corporations are finding it difficult to raise money for expansion especially at a time when the need for large capacity is great.

Corporation bonds floated during 1947 totaled $3,300,000,000, a record gain of $1,300,000,000 over 1946.

Bank loans in 1947 jumped $7,000,000,000 to reach a record of $42,600,000,000. As a result, commercial banks have become a major source of new money for United States business enterprise, thus making them a more important source

than the security market.

Insurance companies have been another important source of finance to American industry.

Business investment in plant, equipment, and inventory in 1947 is estimated at $25,000,000,000. Most of this came from undistributed earnings. New money raised in 1947 in the investment markets provided only a sixth of the total funds required by business.

Corporations are finding out that new money is becoming more difficult to acquire. Banks and insurance companies are tightening their terms and are more cautious in advancing loans. Corporations have drawn heavily on cash reserves and cannot get all the money they need from retained earnings.

Bond prices have declined, raising the average interest yield from 2.4 per cent in 1946 to 3.13 per cent late in 1947, making new issues carry higher interest rates.

It can be seen that sources of new capital funds show signs of shrinking. Corporations are coming to the place where they will have to postpone plans of expansion and so on because of the difficulty of obtaining funds at terms they would like.

The causes of the sluggishness of investment are bound to be many, the major factor being that of uncertainty concerning the business outlook. Some hold that the present inflation period will lead to trouble and during this trouble

they can pick up securities at lower prices.

Investment money, as a result of this uncertainty, is going into channels of savings banks, building and loan societies and other investment istitutions.

Investors are wary of expansion. When large expansion programs are announced by corporations, their stock tends to go downward in price.

With the break-even point higher in corporations, investors are afraid of losses as a result of a moderately downward adjustment in output.

Speculation in securities is low, which also tends to weaken the market. Credit for speculation in stocks is harder to obtain, which also lessens speculation.

Taxes are also involved in the discouragement of individuals to invest their savings. Income taxes are high, leaving less money after expenses for saving and investments. Corporate taxes are another factor which depresses the market with double taxation furthering discouragement.

As can be seen the issuance of securities by corporations to obtain more funds is becoming more difficult and the borrowing of funds is being somewhat restricted. Investors are requiring more safety with somewhat of a steady income, thus making the financing of corporations more difficult. (1)

1. The figures for this section were taken from
   United States News, January 23, 1948
   "Sluggish Stock Market - Why"
   Reported by New York and Philadelphia, p. 40-41

E. Growth Factor of American Industries

Generally speaking any company or industry with prospects of expansion is labeled as a growth company. Another definition is those companies whose earnings move forward from cycle to cycle.

Growth securities always prove attractive to investors because of their long-term profit possibilities. The returns from such companies may change from an initial modest increment to an ultimate vast outpouring of wealth.

The field where growth companies are most likely to be found is generally in the dynamic industries.

The major dynamic industry is the chemical industry, the reason being its close relationship to ever-expanding industrial economy. Another field is the petroleum industry, in which oil has become the wheelhorse of industrial progress. Broadly, the machine industry is another source of growth companies, since machines of every type are needed in our standard of living.

There are many other dynamic fields which can be searched for real growth potentials.

In the case of dynamic industries the current trend is toward common stock financing. The growth trend provides tremendous appreciation possibility and the common stock offers the best means for obtaining such appreciation. It is also in the future growth of industries that the investment banker will play a vital role.

F. Foreign Markets for Capital

It is a well known adage in economic circles that af foreign trade goes so go the profit and loss statements of American industries. We can make a fair profit or return on capital within our own country, but the foreign markets are needed for those extra profits, which in turn help many a business through hard times.

Thus, there is a great future in foreign markets for American capital investment bankers already know and realize this. It may take some considerable length of time before these markets can be opened and the actual issues lined up, but open up they will and when they do the Investment Banking business will gain impetus.

It is argued by some that if foreign nations build up industrial machines it is harmful to our own American business volume. This is only partially true. Certain specific industries might be hurt to a marked degree and others only slightly. But it is on the building up of these foreign industries that the real future growth and the sizable profits of American industry depend.

Already South America has become a good customer for American capital. Within the next ten years, this large continent to our south, with so many natural resources which we so badly will need in the future, should become a tremendous customer of Investment Bankers.

After the Marshall Plan is completed, the European

Continent also should open up vast new financing proposals, to say nothing of the Far East.

True, ventures in foreign countries, particularly those involving large amounts of capital are hazardous at best, but vast sums were made in the early days of this nation by English financeers with risk capital and a sound vision. The same can be accomplished by the Investment Banking industry if it continues to have the sound vision it has shown in the past. In foreign markets for capital lies the real expansion possibilities for the industry.

G. Basic Soundness of American Banking Business

Our general economic life is not complete without the investment banker. His importance is vital, as can be be seen by the responsibility that rests with him. He helps in the expansion of business and aids people to find employment for their savings. Thus, he helps to create jobs for workers. His services, in some way, affect the lives of all of us.

The investment banker helps corporations and government units to secure long-term funds for expansion as well as short-term capital for the financing of current operations. The investment banker may raise the money as has been mentioned in the preceding chapters, through the sale of bonds, notes, stocks. Regardless of the type of security, the investment banker is concerned with the setting up and distribution of the issued securities along with the maintaining of a continuous

ready market for securities.

The investment banker performs two major functions in his activity. In the first place, he aids the business enterprise in deciding upon the type of security and terms best suitable. He also helps to set up the offerings which are suitable to corporate requirements. On the other hand he advises and gives out information to investors regarding investments, in which he cultivates desirable customers for the securities.

Business enterprises are not the only issuers of securities that the investment banker serves. Some investment bankers handle civil loans, that is government, state, municipal and taxing subdivision bonds or notes. The governmental units often utilize their services to secure funds in order to build buildings and make many public improvements.

Primarily the service of the investment banker is to those who need money, however, he performs very definite services to investors. From the investor's standpoint, the investment banker makes it possible for any person throughout the United States to put savings in profitable and productive enterprises.

The investment banker makes investigations into companies issuing securities which the investor is unable to make, thus supplying the investor with important and valuable information.

Another important function which is administered by

the investment banker is that of providing facilities for the purchase and sale of unlisted securities.

As a result of these functions, the investment banker creates a multitude of jobs for those who are in need of work. This is made possible through the commitment of long-term private investment which is a dynamic element in our economic system. These are jobs created in the building of new plants and expansion of old ones. Also, thousands of new jobs are awaiting when the expansion has been completed.

Thus, the responsibility of the investment banker is to the individual and to society in general. As can be seen, he has recognized this responsibility and has measured up to it to a large degree. This is shown through the reflection in investments of insurance companies, savings banks, commercial banks, and individuals. They have absorbed a large portion of securities sold by the investment banker which are now a storehouse for a large portion of the wealth of the world.

Past history not only shows how successful the investment banker is, but it also indicates how necessary is his work. Without the investment banker, who provides the proper flow of funds in the correct channels, there would be a retarding of the accumulation of wealth, industrial activity, and the general advance of society.

Understanding his responsibility, the investment banker has constantly worked toward the fulfillment of his duties. He has perfected a system for the investment of

savings of society and also has provided business enterprises with capital.

His prominence and position is not achieved overnight, or by luck or fortune. Such a position must be earned by long years in which uncompromising integrity, thorough knowledge of securities, and comprehensive facilities and organization are devoted to serving the best interest of investors.

Investment bankers who have established themselves by this method can be depended upon to continue serving those needing funds and those who wish to invest their funds, with ever-increasing resources and understanding.

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